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UK Commercial Market in Minutes
Downward pressure on prime yields resumes, but capital value growth is slowing

June 2015

Downward movements in yields expected in six sectors

■ While the average prime yield for all 13 segments of the market ticked upwards to 4.61% this month, we have also flagged the return of downward pressure on prime yields in six segments of the market.

■ West End and City office yields are now at their lowest ever levels, and the majority of other sectors are at or within 25bps of their long-term lows.

■ While investor demand is becoming more flexible on quality and location, there is still a strong bias towards prime. We are seeing relatively limited levels of new prime stock being brought to the market at present, and this is increasing downward pressure on yields, particularly for office and industrial properties. While we do not expect a significant bounce in investor demand due to the election result, the worsening situation in the Eurozone may well boost demand for the UK.

■ While prime and secondary yields in some segments still have potential to harden, the rate of capital value growth has started to slow (Graph 1).

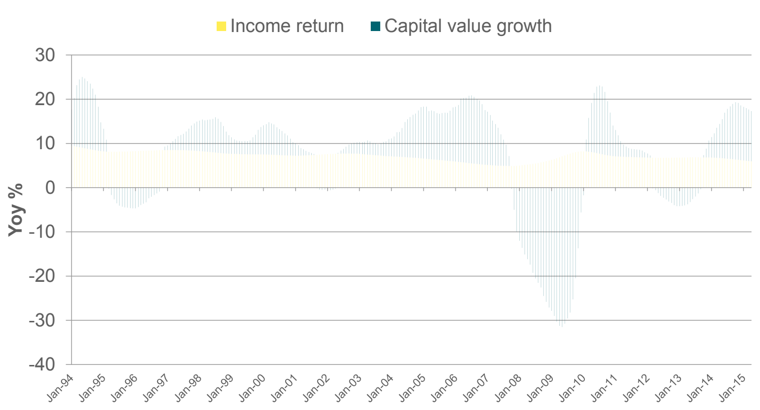
■ The May 2015 All Property index from IPD shows that the annual rate of capital value growth has slowed from its peak of 12.95% in the year to October 2014, to its current level of 11.04% for the year to the end of May 2015.

■ This is a clear indicator that the early phase of the recovery is now ending, and that we are now moving into the phase of the cycle where the majority of the total return will be driven by the income return and rental growth, rather than just capital value growth.

■ The challenge for investors over the next five years will be finding the asset managment and rental growth opportunities that will deliver supra-normal returns.

GRAPH 1

All property capital value growth has started to slow



Graph source: Savills, IPD

TABLE 1

Prime yields

	May 14	Apr 15	May 15
West End Offices	3.25%	3.25%	3.00%
City Offices	4.50%	4.25%	4.25%
Offices M25	5.50%	5.00%	5.00%↓
Provincial Offices	5.25%	5.00%	5.00%↓
High Street Retail	4.50%	4.25%	4.25%↓
Shopping Centres	4.75%	4.25%	4.25%↓
Retail Warehouse (open A1)	4.75%	4.25%↑	4.50%
Retail Warehouse (restricted)	5.50%	5.25%↑	5.50%
Foodstores	4.25%	5.00%	5.25%
Industrial Distribution	5.25%	4.75%	4.75%↓
Industrial Multi-lets	5.50%	5.00%	5.00%↓
Leisure Parks	6.00%	5.25%	5.25%
Regional Hotels	6.50%	5.75%	5.75%

Table source: Savills

The outlook for rental growth - no longer just a London story

■ While London office and retail remain at the top of the tree amongst our forecasts for rental growth over the next five years, the big change in our forecasts from 12 months ago is the recovering rental growth prospects for other sectors and regions (Graph 2).

■ The two themes that we expect to prevail in the occupational market over the next five years are firstly an outward ripple of recovery in tenant demand from London, and secondly an under-supply driven bounce in rents in some subsectors.

■ The ripple trend is a fairly traditional one, benefitting the South East and key regional cities before the rest of the UK. Indeed, we are already seeing upward pressure on prime office rents in most of the top nine regional cities due to a 10% rise in leasing activity, and a 10% fall in availability.

■ The other theme throws out some more suprising prospects for better than average rental growth. In particular we are expecting stronger than normal rental growth from the industrial sector, where take-up was up 40% in 2014, leading to Grade A availability halving in some UK regions.

■ In the retail sector we are forecasting that the strongest rental growth outside central London will come from retail warehousing. While the majority of that sector remains overrented, there has been a dramatic reovery in tenant demand (particularly for bulky goods units). Furthermore, the overall vacancy rate for that sector has fallen from nearly 12% to 7%, and the development pipeline remains very restricted. Finally, we believe that retail warehousing remains the most internet-friendly part of the retail property market, as well as being the most likely segment to benefit from the housing market recovery.

Financing Property: is the debt market overheating?

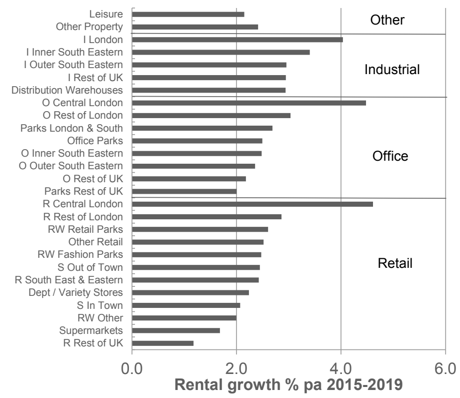
■ We have just completed our 27th annual Financing Property presentations, which cover the state of the nation and prospects for property lenders. The theme of this year's series of events was "Too much competition? Where are the best opportunities?"

■ There is undeniably a lot of competition for lenders in today's market, with over 150 new entrants to the market over the last three years. However, the majority of these lenders are focusing on similar segments of the market, and we believe that good opportunities still exist in providing finance for less competitive area such as development, secondary assets, regional portfolios, alternatives, and smaller-ticket investments.

■ The combination of a very low five year swap rate, and strong competition amongst lenders, means that the cost of money for borrowers has never been so low (Graph 3). While LTVs have risen, we believe that they remain sustainable and are not indicative of a lack of caution in the lending market.

GRAPH 2

Best rental growth will continue to come from London, but other sectors and regions look solid



Graph source: Savills

GRAPH 3

A great time for borrowers - the cost of money is at near record lows

Graph source: Savills, De Montfort University, Bloomberg

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